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No. 675

In the Supreme Court of the United States

October Term, 1913

THE DETROIT EDISON COMPANY, PETITIONER

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 38–42) is reported in 45 B. T. A. 358. The opinion of the Circuit Court of Appeals (R. 47–54) is reported in 131 F. 2d 619.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 30, 1942 (R. 47). The petition for a writ of certiorari was filed on January 26, 1942, and was granted on March 1, 1943 (R. 55). The jurisdiction of this Court rests upon

Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where taxpayer agreed to supply electric energy to consumers in outlying areas only upon condition that the necessary extension lines would be built or paid for by the consumers, is taxpayer entitled to a deduction for depreciation of such lines under Section 23 (l) of the Revenue Act of 1936?

STATUTE AND REGULATIONS INVOLVED

The pertinent statutory provisions and regulations are set forth in the Appendix, *infra*.

STATEMENT

This case involves petitioner's income tax liability for the years 1936 and 1937, and more particularly, its right to depreciation deductions with respect to certain facilities constructed with funds contributed by its customers. The facts, as stipulated (R. 15–37) and as found by the Board of Tax Appeals (R. 38–41), may be stated as follows:

The petitioner is a New York corporation, licensed to do business in Michigan (R. 15, 38). It is a public utility engaged, among other things, in the generation and sale of electric energy in and around the City of Detroit, and operates under the jurisdiction of the Michigan Public Service Commission (R. 16, 38).

In connection with the distribution and sale of electric energy, petitioner from time to time receives applications for the extension of its transmission or distribution lines to places which in its opinion are situated too far from existing transmission or distribution lines to warrant the expenditures necessary to make such extensions (R. 16, 38–39). Nevertheless, if the applicant agrees to pay the estimated cost of construction, it has been petitioner's practice to agree to provide the desired extension. The agreement between the petitioner and the applicant is evidenced by one of five types of contracts, which are reproduced in full in the stipulation of facts herein (R. 16, 21–37, 39).

The amount of the payment made by the applicant is the estimated cost, and not the actual cost, but it never exceeds the actual cost of constructing the requested line extension, and no increase or decrease is made in the amount fixed in the contract upon the completion of the line extension by reason of the actual cost thereof (R. 16, 39). In two of the form contracts (types III and V, R. 28–31, 35–37) there are no provisions for any refunds to the applicant. In the remaining three, the company agrees that it will over a period of five years refund annually either one-half of the revenues derived from the extension (types I and II, R. 21–28) or $60 for each additional customer served by the extension (type IV, R. 31–34); in

no event, however, may the aggregate refund exceed the original contribution, and no additional refunds may be made after the expiration of the five-year period.

The material and property used in the construction of the line extension and the cost of labor are in all cases paid from the general working funds of the petitioner. The records of the petitioner set forth and identify all work performed and to be performed under the provisions of any given contract (R. 16; 39). Upon the completion of the line extension, the petitioner, in accordance with standard practice, enters upon its books as a "property item" (such as poles, lines, etc.), the cost of the line extension, including labor and material, and does not subtract from that sum the amount of the payment made by the applicant (R. 17, 39).

The cash payment made by the applicant in those contracts providing for refunds is not earmarked for the building of any given line extension, but upon its receipt becomes a part of the free working capital of the petitioner. However, the cash payment is entered in what is apparently a suspense account identified as "Customers' Deposits for Line Extensions," and after the five-year period has elapsed the portion remaining unrefunded is transferred to surplus through the medium of an account identified as "Contributions for Extensions." And in the

case of the contracts which do not provide for refunds the cash payment is entered at once in the latter account (R. 17–18, 39–40).

During the years 1936 and 1937 the petitioner thus credited $36,065.81 and $47,500.67 to surplus which represented the balance of customers' payments which became unrefundable in each of those years, respectively (R. 20, 40). Petitioner did not report, nor did the Commissioner seek to tax those amounts as income (R. 20, 40).

The Commissioner did determine, however, that the petitioner was not entitled to depreciation with respect to that portion of the cost of the line exensions represented by the unrefunded balances. The unrefunded (and unrefundable) balances of the deposits at the close of each of the years 1935, 1936, and 1937 were as follows (R. 19, 40):

1935	$1,148,679.86
1936	1,184,745.67
1937	1,232,240.34

The elimination of the unrefunded balances from the depreciable base[1] resulted in a disallowance of depreciation deductions for 1936 and 1937 in the respective amounts of $40,273.11 and $41,786.26 (R. 21, 41). The Board of Tax Ap-

[1] In determining the deficiencies, the Commissioner excluded from the depreciable base the mean of those balances between the beginning and close of each of the taxable years 1936 and 1937. Thus, he eliminated $1,166,712.77 from the base for 1936, and $1,208,496.01 for 1937.

peals sustained the Commissioner's determination (R. 38–42), and the Circuit Court of Appeals affirmed (R. 47–54).

SUMMARY OF ARGUMENT

Section 23 (l) of the Revenue Act of 1936 authorizes a deduction on account of depreciation, and Sections 113 and 114 prescribe the basis for computing that deduction, i. e., Section 23 (l) determines *whether* the deduction is allowable, and Sections 113 and 114 determine *how much* the deduction shall be.

A deduction for a depreciation allowance is permitted by Section 23 (l) only where the claimant actually suffers depreciation. Depreciation can be said to be suffered by the claimant only where it bears the burden of the economic loss due to the exhaustion of the property. Petitioner here, having agreed to furnish electric energy to consumers in outlying areas upon the sole condition that such consumers would build or pay for the necessary extension lines, has made no capital investment on which it is suffering a present economic loss. The very purpose of the arrangement with petitioner's consumers was to relieve petitioner of the burden of making any capital investment and suffering a loss thereon.

The mere existence of an obligation on the part of petitioner to replace the lines in the

future does not satisfy the requirement that it shall have made a capital investment on which it is suffering a present loss. If and when petitioner does replace these facilities it will thereafter be entitled to depreciation deductions measured by the cost of such replacement.

The basis provisions in Sections 113 and 114 furnish further support for our position that no depreciation is allowable here under Section 23. Section 113 (a) deals with an "unadjusted basis," while Section 113 (b) prescribes the use of an "adjusted basis" which is expressly made applicable to the depreciation deduction by Section 114. And in spelling out the method of determining the "adjusted basis," subdivision (1) (A) of Section 113 (b) explicitly requires in sweeping language that proper adjustment in basis shall be made for "expenditures, receipts, losses, or other items, properly chargeable to capital account." The contributions by petitioner's customers in this case were certainly "receipts" within the meaning of the foregoing provisions, and must therefore be carved out of the basis of the property in question.

Neither Section 113 (a) (2) dealing with "gifts," nor Section 113 (a) (8) dealing with "contribution to capital" requires a different result.

If petitioner is allowed the depreciation deduction claimed, not only will it reap the benefit of an expense which it expressly refused to bear, but

the result will be that the payments in question, having escaped taxation when received, would be used again to exempt from taxation earned income which would otherwise be taxable. Such a result was never intended by the applicable statutory provisions.

ARGUMENT

PETITIONER, HAVING MADE NO CAPITAL INVESTMENT IN THE LINE EXTENSIONS BUILT OR PAID FOR BY ITS CONSUMERS, IS SUFFERING NO ACTUAL LOSS THROUGH DEPRECIATION OF SUCH LINES AND IS THEREFORE ENTITLED TO NO DEPRECIATION DEDUCTION THEREON

1. Section 23 (l) of the Revenue Act of 1936 (Appendix, *infra*) provides that in computing net income there shall be allowed as a deduction a reasonable allowance for the exhaustion, wear and tear of property used in the taxpayer's trade or business. If depreciation is thus to be allowed a taxpayer by virtue of Section 23 (l), then Sections 114 and 113 of the Revenue Act (Appendix, *infra*) outline the basis upon which the depreciation allowance is to be computed. See Treasury Regulations 94, Article 23 (l)-1, Appendix, *infra*. In other words, Section 23 (l) determines *whether* depreciation is to be allowed, and Sections 114 and 113 prescribe the basis to be used in determining *how much* depreciation is to be allowed. Cf. *United States* v. *Ludey*, 274 U. S. 295. Since the income tax law is concerned only with losses that are actually realized (cf. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449), in determining whether depreciation is to be allowed within the meaning

of Section 23 (l), there is in addition to the conditions explicitly set forth in that section, the further inherent prerequisite that the claimant actually *suffer* depreciation—that is, that the burden of the economic loss due to the exhaustion, wear and tear of the property actually be borne by it. The basis provisions in Sections 113 and 114 merely specify the measure of the deduction on account of loss, depreciation, etc. They do not determine whether the deduction is allowable.

The distinction is well established. In *United States* v. *Flannery*, 268 U. S. 98, the taxpayer had purchased certain stock prior to March 1, 1913, and had sold it in 1919 for more than its cost but for less than its value on March 1, 1913. The provisions of the applicable revenue act corresponding to Section 113 herein, provided that the basis of property acquired prior to March 1, 1913, should be its value as of that date. Thus, although the taxpayer actually realized a profit upon sale in 1919, he claimed a deductible loss because the sale price was less than the basis (i. e., the March 1, 1913, value) of the stock. This Court held, however, that the basis provisions could not be utilized to provide a deduction on account of loss unless it is first established that there is an actual loss. Compare *McCaughn* v. *Ludington*, 268 U. S. 106; *Helvering* v. *Owens*, 305 U. S. 468.

2. The foregoing principles are fully applicable to deductions for depreciation. It has frequently

been held, both by this Court and the lower courts, that the taxpayer must show an actual impairment or diminution or exhaustion of his capital investment in order to establish a right to the deduction. It is therefore clear that depreciation cannot be allowed where the taxpayer has made no capital investment in the property, for his capital investment is not being impaired. Thus, in *Weiss v. Wiener*, 279 U. S. 333, the lessee of a 99-year lease undertook to maintain buildings on the leased premises in their original condition, but had not as yet made any payments for the estimated depreciation. In denying to the lessee a deduction for depreciation claimed under statutory provisions identical with Section 23 (l), this Court, speaking through Mr. Justice Holmes, said (p. 336):

> But it is very clear that as yet the capital of the lessee has not gone into it, and upon the considerations just mentioned it is not enough that he has made a contract that very possibly may not be carried out to replace that capital at some future time. If, as we think, such a contract is not enough to cause the lessee a present loss by wear and tear, the fact, which may be assumed, that the property was used by him in his business, does not matter. Of course he must show an interest in the property *and a present loss to him* to make the statute apply. [Italics supplied.]

To the same effect see *New York Cent. R. Co.* v. *Commissioner*, 79 F. 2d 247 (C. C. A. 2d), certiorari denied, 296 U. S. 653; *Tunnel R. R.* v. *Commissioner*, 61 F. 2d 166 (C. C. A. 8th), certiorari denied, 288 U. S. 604; *Belt Ry. Co.* v. *Commissioner*, 36 F. 2d 541 (App. D. C.), certiorari denied, 281 U. S. 742; *Brevoort Hotel Co.* v. *Reinecke*, 36 F. 2d 51 (C. C. A. 7th). Cf. *City Nat. Bank Bldg. Co.* v. *Helvering*, 98 F. 2d 216 (App. D. C.). On the other hand, however, if the lessee actually makes the capital investment in the depreciating property, he thereafter suffers a present economic loss through the exhaustion thereof, and is entitled to an annual allowance for depreciation. *Duffy* v. *Central R. R.*, 268 U. S. 55. See also *George H. Bowman Co.* v. *Commissioner*, 32 F. 2d. 404 (App. D. C.); *Kaufman-Straus Co.* v. *Lucas*, 12 F. 2d 774 (C. C. A. 6th); cf. *National City Bank of Seattle* v. *United States*, 64 C. Cls. 236, certiorari denied, 276 U. S. 620. Conversely, in a situation such as that presented in *Weiss* v. *Wiener*, it has been uniformly held that the lessor also is entitled to no depreciation allowance, since although such lessor may have originally made a capital investment, it suffers no present loss thereon because the lessee has covenanted to make that loss good. *Atlantic Coast Line R. Co.* v. *Commissioner*, 81 F. 2d 309 (C. C. A. 4th), certiorari denied, 298 U. S. 656; *Georgia Ry. & Electric Co.* v. *Commissioner*, 77 F. 2d 897 (C. C. A. 5th), cer-

tiorari denied, 296 U. S. 601; *Commissioner* v. *Terre Haute Elec. Co.*, 67 F. 2d 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624; cf. *Terre Haute Electric Co.* v. *Commissioner*, 96 F. 2d 383 (C. C. A. 7th).

It is apparent, therefore, that petitioner in the instant case, before it can successfully claim an allowance for depreciation, must establish the fact that it has made a capital investment in the property involved, and that it is suffering a present actual loss due to the depreciation of that investment. The mere fact that petitioner may have had legal title to the depreciating equipment, used in its trade or business, will not suffice to permit it a deduction for depreciation if it cannot show that it is sustaining a present loss through the depreciation of a capital investment which it has made. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.* See also *Barbour* v. *Commissioner*, 44 B. T. A. 1117, 1121; *Gladding Dry Goods Co.* v. *Commissioner*, 2 B. T. A. 336, 337. Similarly, the absence of legal title will not prevent its taking the deduction if it were actually suffering a present loss of its own capital investment. *Duffy* v. *Central R. R., supra;* cf. *Helvering* v. *Lazarus & Co.*, 308 U. S. 252; and cf. *Colony Coal & Coke Corp.* v. *Commissioner*, 52 F. 2d 923 (C. C. A. 4th). Likewise

not controlling on the question of whether taxpayer is entitled to a depreciation allowance is the existence or absence of a future obligation on the part of taxpayer to replace the depreciating property at the expiration of its useful life. If it has made the capital investment and is suffering the loss thereon, it will, if it meets the other requirements of the statute, be allowed depreciation, although in fact it may not be obligated to replace that investment. If it has made no capital investment, the mere existence of a future obligation to replace the property will not suffice to give it a depreciable interest in that property. *Weiss* v. *Wiener, supra.* If, as, and when it fulfills that future obligation to replace and makes its own investment, from that time on, but not before, will it begin to suffer a loss. *New York Cent. R. Co.* v. *Commissioner, supra,* p. 251; *Belt Ry. Co.* v. *Commissioner, supra,* p. 542.

3. It is the Government's contention that petitioner here has made no capital investment in the property on which it seeks a depreciation allowance. As a result, it cannot be said that it is suffering a present loss on any capital investment made by it, and it is therefore entitled to no deduction for depreciation within the meaning of Section 23 (l) of the Revenue Act of 1936.

The facts reveal that the petitioner, in connection with the distribution and sale of electric

energy, from time to time receives applications for extensions of its transmission or distribution lines to places which, in petitioner's opinion, are situated too far from its existing lines to warrant expenditure of the amounts necessary to make such extensions. In such case petitioner, prior to the construction of the desired extension, requires the applicant to pay to it a sum representing the estimated cost of such construction. It is obvious, therefore, that the very purpose of the arrangement made by taxpayer with its applicants is to relieve taxpayer of the burden of making an investment of its own capital.[2] Only if that burden were assumed by the applicants would the taxpayer consent to enter into any agreement to furnish such applicants electrical energy. And yet having successfully shifted the burden of the required capital investment to its consumers,[3] taxpayer insists

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[2] Each of the contracts under which the consumers agreed to pay for the cost of required additional extension lines provided (R. 21-22, 25, 28-29, 31-32):

"Whereas, the Company *does not consider warranted at the present time the investment in poles, wires, etc., necessary* to extend its lines to the place where the said service is desired;

"Therefore it is Agreed * * *. [Italics supplied.]

[3] Petitioner's Account No. 255, to which were credited all sums contributed by applicants and which were not to be refunded, reads in part as follows (R. 17):

"To this account shall be credited contributions in money or property made to the accounting company *for the purpose of assuming the burden of* [*sic*] *any part of the burden*

that the loss due to the depreciation of that investment is being suffered by it. In other words, the very loss which it expressly refused to assume, it now asserts that it did assume. The taxpayer's contention is, in effect, that the present situation is to be treated precisely the same as if it had required no contribution from its consumers, but had instead agreed to invest its own capital in building the property in question.

It is true that taxpayer has legal title to the property, which is being used in its business; but as has been previously pointed out, this fact alone is not sufficient to establish the prerequisite of a present loss in a capital investment. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.*

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represented by the investment necessary for the establishment or extension of services rendered by the company. This covers such items as contributions toward the cost of line extensions in sparsely settled territory made by consumers, either voluntarily or when reasonably required by the company as a condition of giving the desired service, and the cost of services to which the company has title, in so far as *such cost is borne by the consumer;* * * *." [Italics supplied.]

'It is pertinent to note that in respect of the poles furnished and owned by the applicants in accordance with the contract set out in Exhibit V (R. 35), taxpayer seems quite willing to concede that it is entitled to no depreciation upon such property, although obligated to replace it. As to this property, taxpayer in its reply brief below declared (p. 5), "The utility could not take depreciation, for it does not own the property and suffers no depreciation on it." But, as has

It may be likewise true that the taxpayer is obligated to replace the extension lines when their useful life is ended; but, again, the existence of such future obligation does not suffice to establish a capital investment upon which a present actual loss is being suffered. *Weiss* v. *Wiener, supra.* Cf. *Brown* v. *Helvering*, 291 U. S. 193. When the taxpayer fulfills that obligation and in fact makes its own capital investment, it will thereafter be entitled to a depreciation allowance. *New York Cent. R. Co.* v. *Commissioner, supra; Belt Ry. Co.* v. *Commisisoner, supra.* Until such time, however, it cannot be said to be suffering a present loss through the depreciation of property in which it has refused to make any capital investment. The existence of a capital investment imports the laying out of money or money's worth for the acquisition of an asset for use in the business, and it is the very laying out of such money for the acquisition of a capital investment which petitioner expressly did "not consider warranted at the present time." Cf. *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 388; see also *Steele-Wedeles Co.* v. *Commissioner*, 63 F. 2d 541 (C. C.

been previously pointed out, the question of whether a claimant suffers depreciation depends not simply upon whether it has legal title to the property, but upon whether it is incurring a present loss due to the depreciation of a capital investment which it has made. If taxpayer here suffers no depreciation upon the property furnished in accordance with Exhibit F, it is difficult to understand how it suffers depreciation upon any of the other property here involved.

A. 7th). Cf. *Golden Cycle Corp.* v. *Commissioner*, 51 F. 2d 927 (C. C. A. 10th). It is manifest that before it entered into the contracts with its consumers, taxpayer had no capital investment. At the expiration of the life of the property paid for by the applicants it will also have no investment. In the interim, it is not bearing the burden of any present loss.

Had petitioner here invested its own capital in erecting the extension lines in question, and leased such lines to its consumers, the latter agreeing to replace the property at the expiration of its useful life, it seems clear that taxpayer would not be suffering a present loss due to the depreciation of such property because of the agreement on the part of the lessee-consumer to make that loss good. *Atlantic Coast Line R. Co.* v. *Commissioner, supra; Georgia Ry. & Electric Co.* v. *Commissioner, supra; Commissioner* v. *Terre Haute Electric Co., supra.* If the existence of a future obligation on the part of a third party to make good any loss resulting from the depreciation of the claimant's capital investment is sufficient to preclude the latter from taking an allowance for depreciation, it would appear *a fortiori* that a claimant, who obtains not simply the *future* obligation of another to make good any loss which might result, but obtains instead, as did taxpayer here, the actual present assumption of that loss by another, is entitled to no allowance for depreciа-

tion. Taxpayer here is, we submit, precisely in the same position it would have been in had it used its own funds to build the lines in question and had then been immediately reimbursed by its applicants for the sums expended. The fact that payment by the consumers was required before petitioner would consent to construct the necessary lines cannot alter the substance of the transaction. In either case, taxpayer has already recovered any loss which it might otherwise have suffered.

Had the applicants in the instant case agreed not only to make the original capital investment required to build the extension lines, but also to contribute periodically amounts required for the repair and maintenance of such lines, it seems clear that petitioner would not be permitted to deduct the cost of those repairs as an ordinary and necessary expense of its business. Cf. *New York, C. & S. L. R. R. Co.* v. *Helvering*, 71 F. 2d 956 (App. D. C.); and cf. *Glendinning, McLeish & Co.* v. *Commissioner*, 61 F. 2d 950 (C. C. A. 2d). Since depreciation is, after all, nothing more than an operating expense of a business incurred by reason of the exhaustion of capital assets used in that business (*Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, 643), there would appear to be no reason why petitioner should be permitted to deduct such an operating expense when that expense was never borne by it. If in the present case petitioner's applicants had agreed

to pay for or erect not a permanent extension line system, with an anticipated useful life of say, 30 years, but had instead agreed to pay for the cost of constructing each year for a period of 30 years a temporary structure which was expected to endure for one year only, the expense so borne by the consumer obviously could not have been properly deducted by petitioner as an operating expense of petitioner's business. We submit that the mere fact that the expense suffered in the instant case is in the form of depreciation cannot serve to alter the fundamental fact that it is an expense not suffered by the petitioner.

4. We have thus far endeavored to show that the taxpayer is not entitled to a depreciation deduction under Section 23, and we have therefore not considered the provisions in Sections 113 and 114 which merely prescribe the basis for computing the deduction if it is otherwise allowable under Section 23. However, there is nothing in those basis provisions which contradicts our position, and indeed they go far to confirm its correctness.

(a) Section 114 (a) is captioned "Basis for Depreciation," and it declares that the basis upon which depreciation (i. e., "exhaustion, wear, and tear") is to be allowed shall be "the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition" of the property.

It is to be observed that Section 113 (a) deals with an "unadjusted basis," while Section 113 (b) prescribes the use of an "adjusted basis." Obviously a significant difference was intended between the two. And Section 113 (b) (1) indicates an intention to give the very broadest scope to adjustments, so that the computation would accurately reflect the taxpayer's true income. Thus, Section 113 (b) (1) (A) provides:

> (1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—
>
> (A) for expenditures, *receipts*, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property; but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years. [Italics supplied.]

These provisions plainly contemplate that receipts and expenditures with respect to the taxpayer's property may have a critical bearing upon the taxpayer's net investment in the property. As the court below remarked (R. 51), "All expenditures having some reasonable relationship to the asset are a part of its cost and likewise all receipts having some reasonable relationship to the asset, must be deducted from the cost."

The contributions by petitioner's customers were "receipts" within the meaning of Section 113 (b) (1) (A) which certainly had a very direct relationship to the cost of the facilities, and adjustments in those amounts are therefore unambiguously required by those provisions.

(b) Nor may a different result be reached here by treating the amounts received by petitioner as "gifts" under Section 113 (a) (2) which requires a donee to take over the basis of his donor.[3] The contributions here in issue were not "gifts" within the meaning of Section 113 (a) (2). In *Edwards v. Cuba Railroad*, 268 U. S. 628, 632, this Court pointed out that contributions made "in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities." *A fortiori*, the facilities involved in the instant inquiry, being paid for by the consumers in order that they might secure services which they were not otherwise entitled to receive, are not gifts as contemplated

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[3] Section 113 (a) (2) of the Revenue Act of 1936 provides that in the case of property acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor, except that for determining loss the fair market value of the property at the time of the gift shall be used, if lower. The theory of permitting a donee to take depreciation is simply that such donee steps into the shoes of the donor, whose capital investment becomes that of the donee. Cf. *Taft v. Bowers*, 278 U. S. 470 and cf. *Helvering v. Falk*, 291 U. S. 183; but see *Anderson v. Wilson*, 289 U. S. 20.

in the provisions of the Revenue Act relating to gifts.[6] Cf. *Helvering* v. *American Dental Co.*, No. 303, this Term, decided March 1, 1943.

It does not follow that because the payments received by taxpayer were not gifts to it, that the value of those amounts must be treated as the "cost" to taxpayer[7] of the property which it

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[6] Although all of the amounts paid to petitioner have escaped taxation on the authority of *Edwards* v. *Cuba Railroad*, *supra*, it would seem that, unlike the contributions involved in the *Cuba Railroad* case, the amounts furnished to petitioner here are really given as advance payment for services to be rendered. As such they might well be considered taxable income to petitioner when received. Cf. *Texas & Pacific Ry. Co.* v. *United States*, 286 U. S. 285; *Continental Ins. Co.* v. *United States*, 286 U. S. 290; cf. *Helvering* v. *Braun*, 309 U. S. 461. Moreover, there is substantial doubt as to the correctness of the *Cuba Railroad* case, in view of its sweeping ruling that the amounts in question were not *constitutionally* income, and that doubt is underscored not only by the foregoing decisions, but also by such cases as *Boston Elevated Railway Co.* v. *Commissioner*, 131 F. 2d 161 (C. C. A. 1), certiorari denied, No. 609, this Term, and *Helvering* v. *Claiborne-Annapolis Ferry Co.*, 93 F. 2d 875 (C. C. A. 4). However, the Board of Tax Appeals had ruled in cases of this type that the amounts received do not constitute income under the authority of the *Cuba Railroad* case (see, *e. g.*, *Liberty Light & Power Co.* v. *Commissioner*, 4 B. T. A. 155), and the Commissioner was therefore warranted in acquiescing in the taxpayer's treatment of these amounts as tax-exempt. But consistency in treatment at the same time required, in order to reflect the taxpayer's true income, that these amounts be excluded from the depreciable base. And we are informed that such has been the Treasury's consistent practice for at least the past twelve years.

[7] In *Arundel-Brooks Concrete Corp.* v. *Commissioner*, 129 F. 2d 762 (C. C. A. 4th), the court held that the total cost

acquired as a result. The consideration given by petitioner in exchange for the sums advanced by its consumers was the relinquishment by it of its right to refuse to furnish electric energy to those consumers. That consideration cost petitioner nothing.[8] To say here that the "cost" to petitioner of the properties in question is the cost which the consumers paid for those properties produces the anomalous result of saying that the cost to petitioner is what it would have been had petitioner expended its own funds to build the line extensions. If the properties "cost" petitioner the same amount that it would have cost it had no payment been required from its consumers, it is difficult to understand why such payment was required to be made at all. It seems perfectly apparent that the cost of these properties was borne by the consumers, not petitioner; under no other circumstances would petitioner have agreed to furnish electrical energy. To the extent that the properties in question were paid for by

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of the property, by whomever paid, not the cost to the taxpayer, was the proper basis to be used in computing depreciation. It would seem fundamental; we think, that since it is the taxpayer's net income which is subject to income tax, only the costs which it bears should be pertinent in determining its taxable net income.

[8] The "cost" to a taxpayer of property acquired is to be measured not by the value of the property, but by the cost to the taxpayer of what it gave in order to obtain the property. For example, a taxpayer who pays $1,000 for property worth $10,000 has a cost basis of only $1,000.

the consumers, it cannot be said that those properties cost petitioner anything. *Kell* v. *Commissioner*, 88 F. 2d 453 (C. C. A. 5th); *Nashville Warehouse & El. Corp.* v. *Commissioner*, 105 F. 2d 883, 885 (C. C. A. 6th).[10] See also *North American Coal Corp* v. *Commissioner*, 28 B. T. A. 807, 848; cf. *Friend* v. *Commissioner*, 119 F. 2d 959 (C. C. A. 7th), certiorari denied, 314 U. S. 673.

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[9] *Robinson* v. *Commissioner*, 97 F. 2d 552 (C. C. A. 9th), upon which taxpayer relies (Br. 22-25), is not inconsistent. It involved the question of determining the amount of gain realized from the sale of bonds and stock, and the Commissioner's determination fixing the basis of the bonds and stock at precisely the amount of funds which the taxpayer had expended from his own pocket was sustained.

[10] There were two issues involved in this case. As to the second issue, it appears that the taxpayer contracted with another company to erect certain bins and tanks, $140,000 of the cost of which was to be paid by such other company. It was held that only one amount in excess of $140,000 which was paid for by taxpayer could be considered as its cost basis. As to the first issue, the facts revealed that the taxpayer purchased certain property for $40,000, payable in installments, and paid all but about $13,000 of the purchase price out of the proceeds of fire insurance collected upon the destruction of the property. We submit that the decision of the court holding that the cost of the property to the taxpayer was $40,000 offers no support to petitioner's claim here. Had the taxpayer used $27,000 of the insurance proceeds to purchase a new capital asset rather than pay the purchase price on the destroyed property, clearly that $27,000 would have formed a part of its cost basis. In either case it has made a capital investment with its own funds.

Helvering v. *Gowran*, 302 U. S. 238, is analogous. There, the owner of common stock in a corporation received a dividend in preferred stock of the same corporation which was not taxable under the applicable revenue act. He thereafter sold the preferred stock, and was required to report the entire proceeds as income since the Court held that the preferred stock had a "zero" basis. Similarly, here, the taxpayer may not include in the basis of its property that which does not represent its own expenditures.

(c) Finally, there is no foundation for the suggestion that this case is ruled by Section 113 (a) (8) (B) which provides that property acquired by a corporation as a "contribution to capital" retains the basis which it had in the hands of the transferor. In the first place, the provision is literally not applicable because the customers did not transfer the facilities themselves to the taxpayer. In the second place, and more significantly, the amounts in question were not "contributions to capital." Normally, a contribution to capital is regarded as referring to amounts paid in by stockholders or by persons having a proprietary interest in the enterprise. And even if the concept be extended beyond its traditional scope to include contributions by outsiders, it nevertheless can have no application here. For, as indicated by the court below (R. 53), the amounts in question did not become part of "those resources whose dedication to the users

of the corporation is made the foundation for the issuance of capital stock and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation." No such situation existed here. The consumers in no sense made any such contribution. If the company had failed to construct the facilities in question, the consumers would doubtless have been entitled to a refund of the entire amount of the contributions. There is nothing in the regulations relied upon by petitioner (Treasury Regulation 94, Article 113 (a) (8)–1, see Appendix, *infra*, p. 30) which requires any such extraordinary treatment, and the Treasury itself has not so regarded them.

In the final analysis, petitioner is really seeking a double tax benefit from the same transaction. The amounts received from the consumers were not included in its taxable gross income and it seeks at the same time to take a deduction by reason of the gradual exhaustion of the facilities purchased with those funds. Cf. *Hort* v. *Commissioner*, 313 U. S. 28. Such practice is plainly not permitted for rate-making purposes, for the contributions must either be excluded from the rate base or they must be included in the company's earnings. *Re The Detroit Edison Co.*, 16 P. U. R. (N. S.) 59 (Michigan, 1936); *Re Harmony Electric Co.*, P. U. R. 1933A 306

(Michigan, 1932); *Re Northern Power Co.*, P. U. R. 1933C 128, 131 (Michigan, 1932). The result should not be any different for tax purposes, and it should not be presumed that Congress intended otherwise unless its intention were clearly expressed. Not only is petitioner seeking the benefit of an expense which it expressly refused to bear, but the net effect of upholding its claim would be that the payments in question, having escaped taxation when received, would be used again to exempt from taxation earned income which would otherwise be taxable. Certainly, there is no such expression of a legislative purpose to permit the windfall sought herein, and such an intention is "never lightly to be inferred". Cf. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted.

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APRIL 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * *

* * * * * * *

(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired

by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * * * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

* * * * * * *

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, * * *

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

* * * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose

of determining the gain upon the sale or other disposition of such property.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (l)–1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *.

ART. 113 (a) (8)–1. *Property acquired by a corporation after December 31, 1920.*— * * *

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1943

SUPREME COURT OF THE UNITED STATES.

No. 675.—October Term, 1942.

The Detroit Edison Company, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[May 3, 1943.]

Mr. Justice Jackson delivered the opinion of the Court.

The petitioner, The Detroit Edison Company, engages in the generation of electric energy and its distribution to the public in and near Detroit. It receives many applications for service which in its opinion would require an investment in extension of its facilities greater than prospective revenues therefrom would warrant. In such cases it undertakes to render the service if the applicant will pay the estimated cost of the necessary construction. This is done by contract of which there are five variations, some of which provide for refunds of part of the customers' cost if additional customers come in to share it, or if revenues exceed estimates. With these provisions we are not concerned, since the controversy here relates only to payments that never were, or which by the contracts have ceased to be, refundable. The amounts of the customers' payments are fixed by an estimate of the cost; they never exceed, and sometimes fall short of actual cost, but are not adjusted because of the difference between estimates and realization.

The Company constructs the facilities which become its property, and adds the full cost to its appropriate property accounts without deduction for the customer payment. It claims as a base for computing its depreciation the investment for which the Company is then reimbursed. Customers' payments are not appropriated to the particular construction nor earmarked for it, but go into the Company's general working funds. During the period that a payment is subject to refund it is carried in a suspense account; but if it is not subject to refund, or when the refund period is past, the ungefunded and unrefundable balances are

transferred to surplus through an account designated as "Contributions for Extensions."

During 1936 and 1937, the years in question, the Company added to its surplus from such sources $36,065.81 and $47,500.67 respectively. The Commissioner eliminated from the depreciable property of the Company that portion of the cost equivalent to the unrefunded and unrefundable balances of the deposits. These eliminations, amounting to upwards of $1,160,000 in each year, resulted in disallowing depreciation deductions from income of $40,273.11 for 1936 and $41,786.26 for 1937, and in deficiencies which the Company contested. The Board of Tax Appeals sustained the Commissioner and the Circuit Court of Appeals affirmed.[1] Because the decision appeared to conflict with principles followed in another circuit,[2] we granted certiorari.

A deduction from gross income on account of depreciation is permitted by § 23(l) of the applicable Revenue Act in these terms: "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."[3] For the basis we are referred by § 23(n) to § 114 of the Act which refers us again to § 113(b) thereof which provides an "adjusted basis" for gain or loss but which again refers us to § 113(a) for the basis upon which adjustment is to be made. The sum of these is that the basis of depreciation allowance "shall be the cost of such property" [§ 113(a)] making "proper adjustment" in respect of the property "for expenditures, receipts, losses, or other items, properly chargeable to capital account," [§ 113(b)(1)(A)] except in case of certain gifts; transfers as paid-in surplus, or contributions to capital [§ 113(a)(2), (8)(B)], which exceptions we will later consider.

It will be seen that the rule applicable to most business property of a cost basis properly adjusted leaves many problems of depreciation accounting to be answered by sound and fair tax administration. The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to

[1] 45 B. T. A. 358; 131 F. 2d 619.

[2] Arundel-Brooks Concrete Corp. v. Commissioner, 129 F. 2d 762 (C. C. A. 4th).

[3] Revenue Act of 1936, 49 Stat. 1648.

each classification of depreciable property an amount which at the time it is retired will with its salvage value replace the original investment therein. Or as a layman might put it, the machine in its life time must pay for itself before it can be said to pay anything to its owner. Experience and judgment hit upon usable mortality tables for classes of property from which annual rates of accrual are estimated and several different methods are employed for relating this physical deterioration and functional obsolescence to financial statements. The calculation is influenced by too many variables to be standardized for differing enterprises, assets, conditions, or methods of business. The Congress wisely refrained from formalizing its methods and we prescribe no overall rules.

But we think the statutory provision that the "basis of property shall be the cost of such property" [§ 113(a)] normally means, and that in this case the Commissioner was justified in applying it to mean, cost to the taxpayer. A property may have a cost history quite different from its cost to the taxpayer. It may have been purchased for less or more than original cost, or built by contract which called for payments on which the builder profited greatly or suffered heavy loss. But generally and in this case the Commissioner was in no error in ruling that the taxpayer's outlay is the measure of his recoupment through depreciation accruals.

If this were otherwise in doubt it would be made clear by the provisions for "proper adjustment" of cost for receipts properly chargeable to capital account found in § 113(b)(1)(A). The customer payments so far as in question found their way into the Company's capital accounts by way of an addition to surplus. Their interdependency with the increases in property accounts caused by the construction they induced justified the Commissioner in relating the one to the other for the purpose of adjusting the basis for depreciation.

The Company, however, seeks to avoid this result by the contention that what it has obtained are gifts to it or contributions to its capital of the property paid for by the customer, and that therefore by the provisions of § 113(a)(2) and (8)(B) it takes the basis of the donor or transferor. It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. The transaction neither in form nor in substance bore such a semblance.

The payments were to the customer the price of the service. The receipts have gone, so far as here involved, to add to the Company's surplus. They have not been taxed as income, presumably because it has been thought to be precluded by this Court's decisions in *Edwards* v. *Cuba R. Co.*, 268 U. S. 628, holding that under the circumstances of that case a government subsidy to induce railroad construction was not income. But it does not follow that the Company must be permitted to recoup through untaxed depreciation accruals on investment it has refused to make. The Commissioner was warranted in adjusting the depreciation base to represent the taxpayer's net investment. Nothing in the Regulations is to the contrary and nothing in *Helvering* v. *American Dental Company* (No. 303, decided March 1, 1943) — U. S. —, when read in the context of its facts touches this problem at all.

Affirmed.

The CHIEF JUSTICE did not participate in the consideration or decision of this case.

A true copy

Test:

Clerk, Supreme Court, U. S.